The Federal Reserve Board

Remarks by Vice Chair Alice M. Rivlin

The world economy
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I am delighted to be here today and to have this opportunity to talk with you. I am particularly pleased to be here with my friend Congressman John LaFalce, who brings such energy and good sense to the Congress, especially to the hard work of the Banking Committee, which is where I see him most frequently.

I want to talk with you this morning about the turmoil in the world economy and what it might mean for us here in the United States. Why should people in upstate New York care about the economy of Thailand or Russia or Brazil? What can we do to keep our own economy strong?

We are all used to the cliche that the world is getting smaller, that the electronic age has brought us closer and put us in instant touch with remote parts of the globe. We know that cross-border trade and investment have increased enormously in recent years, bringing both greater prosperity and greater interdependence.

Still, when bad news from Asian economies began flashing across our screens in the summer of 1997, it didn't seem to have much to do with us. Currencies with odd names, like the baht and the ringgit were said to be plunging, stocks prices on the Hang Seng or the Nikkei were falling, by the end of the year Korean banks were negotiating with their creditors. But here at home the economy was doing better than it had in a generation. The news from Asia seemed like a small dark cloud appearing on the horizon in the middle of a sunny day at an outdoor festivity. It might mean rain, but with any luck it would go away.

We have been enjoying a truly extraordinary performance of the U.S. economy. Since the beginning of the 1990s, we have had a long period of growth that didn't seem to be sputtering out. In fact, growth accelerated in 1997 and early 1998, which is not the usual pattern for a "mature" business cycle. We have seen few signs of strain or imbalance. Although some areas, including Upstate New York, have lagged, we have experienced mostly good growth across the country and across sectors of the economy.

Unemployment has been very low -- lower than most economists thought it could remain for long without igniting inflation. Wages have been increasing, but not so fast that the rise caused rapid escalation of costs. The slowdown in the rise of health benefit costs has held total compensation increases to moderate levels. Productivity increases have been offsetting compensation growth, keeping profits growing, at least until quite recently. Most remarkable of all, inflation has been falling and not showing any clear evidence of accelerating again.

Even the Asian crisis at first seemed an ill-wind whose timing was actually blowing us some good. Some Americans felt the negative impact early, especially manufacturers whose exports to Asia declined and farmers who saw their prices drop on world markets as Asian demand fell off. At the national level, however, our economy was clearly growing at an

unsustainable rate, and some slowdown was actually welcome. We were in danger of running out of workers. Sooner or later cost pressures would lead to inflation. The primary economic risk seemed to be overheating, not slow growth.

Indeed, the Federal Reserve was concerned enough to tap the brakes by raising the short term interest rate in March 1997 before the Asian crisis hit that summer. We would probably have felt called on to raise rates again later in 1997, but by then it seemed likely that slower growth in Asia would cut US net exports, and restrain our economy enough to avoid inflation and any pressures. Good productivity performance, falling commodity prices, combined with low inflation expectations and the high value of the dollar, all made it less risky to wait and reduced the necessity of the Federal Reserve taking preemptive action against inflation by raising rates again.

The stock market's remarkable rise both reflected and perpetuated the general good feeling about the U.S. economy. Even the Asian crisis raised the price of U.S. stocks, as investors took their money out of Asian markets and bought U.S. securities instead. To be sure, U.S. equity values were outrunning reasonable expectations of profits, especially if, as many forecasters expected, the economy slowed down. But increased wealth of consumers stimulated consumption and the low cost of equity stimulated investments, so chances of future profits were enhanced. Some worried that high equity values were a bubble that would inevitably burst, but this concern was mitigated by: (1) lack of strong evidence that stock prices were part of a wider speculative phenomenon that included real estate and other assets, as in some previous boom periods; (2) the apparent new maturity of small investors, who talked and acted as though they were in the equity market for the long haul. All in all, it was a sunny day at the fair.

All of this good news generated an occasionally silly debate about whether the U.S. was in "new era" in which all the old rules had been suddenly repealed, or whether there was a "new paradigm," which usually seemed to mean "no paradigm," or "the sky's the limit."

The more sensible version of the discussion went something like this. There are lots of reasons why the economy might be both more productive and less inflation prone than it used to be:

- more global competition
- deregulation of airlines, trucking, telecommunications; decline of barriers among financial services
- the computer and telecommunication revolution (finally) making cost savings possible, not just in manufacturing, but in services
- more flexibility and incentives built into wages, less unionization, out-sourcing of specialized services, use of temporary and part-time employees
- high levels of investment, including human investment -- on-the-job and other skill training.

In economists' terms, there was hope that productivity might have moved onto a higher growth trend. Faster productivity growth would mean a higher standard of living for Americans in the future. It would mean that growth could be faster without setting off inflation (perhaps closer to 3 percent a year than 2 percent) and that unemployment could be lower without inflationary consequences. That would be very good news.

It was too soon to be sure that the apparent productivity trend increase would hold up or that less inflation was becoming the norm. It was certainly true that some elements of the unusual

combination of favorable inflation factors were likely to reverse. Health cost increases might accelerate again; the dollar might weaken and cause import prices to rise; oil and commodity prices might go up again. Still, the U.S. economy seemed to be performing remarkably well.

Then ill-wind from Asia turned to a gale, sweeping through currency and asset markets all around the world and affecting our own financial markets as well. The stock market dropped 5 percent in one day in August, then bounced wildly around. A general "flight to quality" drove long-term interest rates down on Treasuries, but rates on riskier financial instruments went up. The market mood changed to pessimism and risk aversion.

In Japan, the Asian crisis had a much greater impact and came at a much worse time. Japan is closely involved with other Asian countries and suffered both financial reversals and loss of markets for Japanese goods. They were already struggling with slow growth, a banking system in need of overhaul and a political party structure in need of rejuvenation. The Asian crisis precipitated deep recession in Japan. The world economic turmoil could not have come at a moment when the Japanese were less able to deal with it.

Meanwhile, across the Atlantic, the initial storm warnings from Asia, were also first dismissed by many Europeans as far away and not their problem -- distant thunder on another shore. European economies are less heavily involved with Asia than we are and, besides, the ill-wind was blowing them some good in the form of lower oil and other commodity prices. The major countries on the continent were working hard on the details of monetary union and organizing a multi-national central bank; they were struggling earnestly to get deficits and inflation down. The basically simple idea of having a common currency and a common central bank proved very difficult to achieve technically and politically, but they had done it. Growth rates were finally picking up and even high French and Germany unemployment rates were beginning to recede. Europeans were optimistic that the common currency, and the increased competition and deepening capital markets it was likely to engender, would energize their economies even more and lead to higher growth. This unpleasant weather on the horizon seemed at first a minor distraction. But the lightening bolt in August of Russian devaluation was more difficult to ignore; it was right there on their borders.

In the last few months, we have learned so much about the downside of an increasingly interdependent world that it is important to remind ourselves that the upside is enormous. Increasing volumes of trade and cross-border investment have raised the standard of living in many emerging countries at an astonishing rate. Trade and foreign investment have moved the countries of Southeast Asia in less than a generation from traditional agriculture to modern industrial societies with far less poverty, much more skilled work forces and rising standards of living. At the same time, we and other industrial countries have benefitted from growing markets for our exports, higher profits on our capital and lower prices for the wide variety of goods we import.

When things are going well in an interlinked world, one country's prosperity reinforces another's. The rapid growth of emerging market countries, especially in Asia, in the last couple of decades, led to greatly increased trade among them as well as with industrial countries. The self-reinforcing growth seemed so positive that investors began to view investing in emerging markets as not much more risky than investing in their own more familiar industrial country markets. Capital flowed freely to finance projects in emerging market countries with lenders demanding only slightly higher interest rates than they would have required to lend at home.

But the downside of interdependence is that when something goes wrong, the impact also spreads quickly from one country to another, through trade channels, prices and asset markets. Asian countries in trouble quickly cut their imports from each other and from the industrial world. The reduced Asian demand for food, oil and raw materials was felt by farmers in the U.S. and Canada, Australia and New Zealand; by producers of oil in Mexico and Venezuela, Nigeria and Russia and the Middle East; by copper producers in Chile and exporters of industrial raw materials in Africa and elsewhere. Companies in Rochester and Buffalo found their sales falling.

As the contagion spread, investments in many emerging market countries began to look less promising. Investors became generally more cautious and began looking for safe places to put their money -- like buying U.S. government bonds -- even at low rates of return. As they saw U.S. companies affected, they became less eager to finance them as well.

We've learned a lot in the last few months about the power of contagious loss of confidence in an interlinked world. The meltdown in Russia was the clearest case. Russia is not an important economic and trading power in itself. Losses to major money center banks, here and in Europe, though magnified by unexpected interrelations with hedge funds and other operations, were not in themselves destabilizing. But what apparently mattered was the surprise, both of the suddenness and unpleasantness of the Russian default and of the fact that the Western "powers" were so powerless. No one thought the U.S. and its allies would take the political risk of letting Russia fall apart. In the end, there was nothing they could do to stop it.

The Russian collapse led investors to pull back just about everywhere. Some who had borrowed to invest in Russia had to sell assets in other markets to cover losses. Others simply said to themselves, "If it can happen in Russia, it can happen anywhere; I had better get my money to a safe place." The result was plummeting markets in Latin America, South Africa, Asia and elsewhere, more difficulties for the countries struggling to recover.

It is now clear that the Asian crisis that started in Thailand in the summer of 1997 -- and seemed like a remote event of no great significance to most Americans -- has set off a chain reaction reaching around the world. Much of Asia is in deep recession, the Russian economy has collapsed with negative repercussions for many of its neighbors, growth is slowing in Latin America. Risk aversion of investors has made it difficult for any country, company or venture perceived as at all risky to get capital or to borrow, even at high rates. Countries like Brazil, Mexico and Argentina, considered quite strong a few months ago, are under mounting pressure. Brazil has had to raise interest rates, use much of its foreign exchange reserves to keep its currency from depreciating; the high interest rates, in turn, have greatly exacerbated Brazil's budget deficit, and the deteriorating outlook has led to fears that investors will pull their capital out and bankers refuse to roll over debts. Economic collapse in Brazil, which is Latin America's largest economy, could precipitate serious trouble in other Latin American countries and then reverberate back around the globe to deepen the trouble of Asia, including Hong Kong, China and Japan. Another round of deepening deterioration would surely put intense downward pressure on the U.S. economy by cutting our exports, depressing equity markets and weakening investor and consumer confidence. As Chairman Alan Greenspan has said, we cannot expect to be an "oasis of prosperity" in a deteriorating world economy. Even if we could stay prosperous alone, we should not want to take the risk that deteriorating economies in the rest of the world would augment unrest, terrorism and international conflict that could engulf the United States.

What's to be done? In the near term there are clearly two priorities:

- Stop the contagion so that emerging market countries can begin to get back on their feet.
- Keep the world's largest economy from slowing down too much -- for our own sake and the world's.

There is no easy, simple answer to stopping contagion, if indeed there is any answer. What would be the elements of a plan?

First, countries most in danger of being the next to fall have to be willing to face up to their vulnerability quickly. (There is no point in moaning, "It's not our fault, we didn't do anything wrong; we just got caught in the world backwash." That's partly true, but not helpful.) They have to be willing to call in their creditors to negotiate rollovers, ask the IMF for conditional loans, offer significant and credible internal reforms in return. Nowhere is this easy.

Second, private creditors have to see their long-run interest in hanging in, even on concessional terms, rather than joining a stampede for the exits.

Third, the international financial institutions and the industrial countries have to find more funding to tide these countries over the crises if they give evidence of willingness to accept strict conditions. Congress' passage of the IMF quota increase and the New Arrangements to Borrow remove a major uncertainty about the effectiveness of collective action and should do a lot to restore confidence that the chain reaction of economic deterioration can be stopped.

Keeping our own economy growing would be important even if the rest of the world were not depending on us so much. Slower growth and rising U.S. unemployment would mean fewer opportunities for Americans to earn income and move to higher skilled and better paid jobs, less chance for families to move out of poverty and from welfare to work. Slow growth or recession in U.S. would also have serious consequences for the rest of the world, reducing our ability to buy and invest abroad and exacerbating economic downturn everywhere.

At present, the chance of recession in the U.S. does not seem high. Recent growth has been strong and balanced with few indications of strains and speculative excesses that typically go with boom/bust cycles. Most forecasters expect the U.S. economy to slow; the hope is that it will not slow too much.

The Federal Reserve, recognizing that the balance of risks has shifted from overheating to cooling off, has cut short term interest rates twice. Other industrial countries may follow our lead (Canada already has); although the major continental European countries feel easing is less appropriate for them as they consummate their monetary union.

It is clearly important for the Japanese to get their economy moving again -- to stop being part of the problem and be part of the solution -- as Americans and Europeans have been pointing out, none too politely, for months.

The Japanese were not shy, when they were riding high in the ‘70s and ‘80s, to offer advice to the Western industrialized countries about modernizing our manufacturing and management practices, working harder, getting budget deficits down. So there may be a payback element to the U.S. and European shrillness about how important it is for the

Japanese to use aggressive fiscal stimulus to get their economy going again and to restore confidence by drastic and immediate restructuring of their banking system. Neither is going well. A series of stimulus announcements, mostly focussed on increasing government spending for public works has not yet succeeded in stemming the economic slide. A next step might be a significant tax cut, but with Japanese consumers and investors both feeling anxious about the future, there is no guarantee that even a large tax cut would result in much near term spending.

Japanese banking system restructuring is going slowly, although it does seem to be moving toward resolution. We are fine ones to talk, since we let our much smaller savings and loan crisis fester for a long time before facing up to it. With hindsight, the Japanese could have restructured their banks much more easily three or four years ago. The worst time to restructure failing banks is when macroeconomic conditions are reducing the value of their assets even further. Drastic action now may make the recession worse in the short run, but it may also be the only hope for restoring confidence and financial health in the future.

Let's suppose this crisis turns around: the contagion is stopped, Asian and other emerging market countries begin to grow again; Japan pulls out of recession and begins to contribute with its recovery to recovery of its neighbors; North America and Europe sustain healthy economies. Then the big question is: how to avoid such a costly episode happening again. The real costs are not monetary; they are disrupted human lives and hopes. Millions of people in emerging market countries are suddenly without jobs, food, basic necessities, children are not going to school, young people are not learning skills, and are facing uncertain futures.

We won't be able to avoid crises altogether. But in the new era of huge capital flows and instant communication, the amplitude and severity and cross border reach of crises are magnified. Can we at least make crises less frequent and mitigate the damage?

What we should *not* try to do is retreat to isolation and self-sufficient economies that don't trade or invest in each other. The simple reason is: we'd all be a lot poorer. That solution is like saying: We don't like power failures, so let's all stop using electricity or make sure that everyone has a generator in the backyard, so we don't have to depend on the power company.

What we can strive for is more cautious better informed investing and lending, better early warning systems and ways of heading off deepening trouble once it begins.

Better information would help:

- All countries giving complete information on their foreign exchange reserves in as close to real time as possible.
- Better information on budgets and government finances, e.g., what real deficits are.
- Companies and banks revealing more clearly what their assets, liabilities and profits are.

More effective, better supervised financial systems are essential:

- Prudential regulation of banks
- More carefully supervised securities markets.
- Accounting standards, enforced.

One idea is that a country's financial systems could be graded by its peers in other countries; somewhat in the manner that universities or hospitals are accredited in the United States and the results published.

The concern should not be just with borrowing countries and their institutions, as though making emerging market countries' financial structures more like the structures in industrial countries would solve all the problems. For every borrower there is a lender. Industrial countries, creditor countries, have to be more sure their banks are managing their risks appropriately, and are prepared to deal with situations when a lot of things go wrong at once.

Finally, we must strengthen international financial institutions so they are better able to assess the health of member countries, give timely warnings of trouble ahead, and provide short term assistance to countries that need to make repairs.

All of this will take sustained effort to learn from past and build a stronger international financial community for future. The process ought to create some interesting, rewarding jobs and challenges for those with an interest in how the economic world works and how to make it better.

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